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No. 52

In the Supreme Court of the United States

OCTOBER TERM, 1932

HUBERT DALTON AND FLORENCE W. DALTON,
PETITIONERS

v.

FRANK C. BOWERS, AS EXECUTOR OF THE LAST WILL AND TESTAMENT OF FRANK K. BOWERS, ETC.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the District Court for the Southern District of New York (R. 66–69) is unreported. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 130–135) is reported in 56 F. (2d) 16.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 23, 1932. (R. 135.) Petition for a rehearing was denied March 14, 1932.

(R. 135–136.) Petition for a writ of certiorari was filed May 2, 1932, and granted May 31, 1932. (R. 136.) Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the circumstances of this case, a loss sustained by Hubert Dalton in 1924, when his stock in the Dalton Manufacturing Company became worthless, was a loss "attributable to the operation of a trade or business regularly carried on by the taxpayer" within the meaning of Section 206 (a) (1) of the Revenue Act of 1924.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations are set forth in the Appendix, *infra,* pp. 16–18.

STATEMENT

The District Court directed a verdict in favor of petitioners (R. 69) upon evidence which may be summarized as follows:

In 1917 (R. 34) petitioner Hubert Dalton, an inventor, designer, and engineer (R. 14, 22), and the owner of certain patents upon his inventions (R. 19, 24, 44, 57, 76–77) organized the Dalton Manufacturing Corporation under the laws of the State of New York (R. 17), and acquired all of the capital stock of the corporation at a cost of $395,000 (R. 17, 32–33, 41). He became president and treasurer and a director (R. 17, 36) and assumed con-

trol of the corporation (R. 36). He assigned some of his patents to the corporation (R. 20, 36, 44, 57, 76–77), and the corporation took over some of the assets of the Dalton Machine Company upon dissolution of that company in 1917 (R. 34–35, 37). In organizing the Dalton Manufacturing Corporation it was Dalton's purpose to have the corporation take over, develop, manufacture, and sell the articles invented by him (R. 37, 42), with a view to making his patented articles well known to the public and the corporate stock held by him more valuable (R. 23).

During the years 1917 to 1924, inclusive, Dalton was in active charge of the business and affairs of the Dalton Manufacturing Corporation.[1] (R. 36.) He derived some income from other investments owned by himself and his wife. (R. 35.) Although the Dalton Manufacturing Corporation credited Dalton with a salary for the years 1917 to 1922, inclusive, he withdrew no money from the corporation (R. 32), and the corporation at no time made a profit (R. 35).

During the years 1917 to 1923, inclusive, Dalton Manufacturing Corporation manufactured and sold Dalton lathes and other articles covered by Dalton's inventions (R. 18, 37), and also purchased and sold dogs, chocks, and collets to be used in connection with the Dalton lathes (R. 43), but the lat-

[1] Dalton spent from eight to ten hours a day at the office of the company during 1923 and five or six hours a day at the office of the company during 1924. (R. 39.)

ter amounted to less than 1 per cent of the corporation's business (R. 18, 43). Between 1917 and 1922, inclusive, Dalton loaned to Dalton Manufacturing Corporation $436,179.30 (R. 31), no part of which was ever repaid (R. 43). During 1923 and 1924 he advanced an additional $72,569.83. (R. 28.) In 1923 the corporation ceased active business operations and took steps to wind up its business. (R. 100.) At the close of 1923 its liabilities exceeded its assets by $176,462.01. (R. 101.)

In a joint return for 1923 Dalton and his wife claimed a deduction of $157,035.50 as a bad debt owing Dalton by the Dalton Manufacturing Corporation. (R. 100.) The assets of the corporation were disposed of in 1924 (R. 53–54, 56, 58) at a price which was less than the corporate liabilities (R. 30–31, 59–60). The corporation was formally dissolved in 1925. (R. 30.)

In a joint income-tax return for the year 1925 Dalton and his wife claimed a deduction of $395,000 representing the cost of the Dalton Manufacturing Corporation stock. (R. 4, 79, 80.) The Commissioner of Internal Revenue disallowed the deduction for the year 1925 (R. 4, 9), but held that the loss was sustained in 1924 and adjusted Dalton's taxes for that year accordingly (R. 6). He determined a deficiency for the year 1925 in the sum of $56,841.32 (R. 7, 14), which was paid under protest.

Suit was instituted in the District Court for the Southern District of New York (R. 2) to recover on one of two alternative causes of action (R. 14).

The first cause of action (R. 2–5) was based upon the claim that the loss was sustained in 1925 and that, therefore, the Commissioner's determination of the deficiency for that year was erroneous. The second cause of action (R. 6–9) was based upon the theory that if the loss was sustained in 1924 petitioners had a net loss for that year of $374,078.98 which they were entitled to carry forward and deduct from their 1925 income of $291,702.31 as determined by the Commissioner, thus entitling them to a return of the $56,841.32 paid under protest as above stated. By stipulation the case was tried to a jury of one (R. 13), each side moving for a directed verdict at the close of the trial (R. 65). The District Court granted petitioners' motion for a directed verdict (R. 69) and in its opinion (R. 66–69) held that even though the loss was sustained in 1924, as determined by the Commissioner, it was nevertheless "incurred in a trade or business regularly carried on by the taxpayer in 1924" (R. 68), and thus could, in part, be carried forward under the provisions of Section 206 (b) of the Revenue Act of 1924 (*infra*, p. 16), and accordingly entered judgment for the petitioners (R. 11–12).

The Collector appealed to the Circuit Court of Appeals for the Second Circuit (R. 127), where, reversing the judgment of the District Court, it was held that the loss was sustained in 1924 (R. 135); that the Dalton Manufacturing Corporation was a legal entity, separate and distinct from Dalton, its stockholder, and that inasmuch as Dalton

chose to do business through the corporation his loss "did not occur in the operation of the trade or business regularly carried on by" him (R. 132). This Court granted certiorari. (R. 136.)

SUMMARY OF ARGUMENT

The right to carry a deduction forward from 1924 to 1925 is limited by Section 206 of the Revenue Act of 1924 (*infra*, p. 16) to losses "attributable to the operation of a trade or business regularly carried on by the taxpayer."

Hubert Dalton, one of the taxpayers herein, purchased all of the stock of Dalton Manufacturing Corporation in 1917 for $395,000, and this investment resulted in a total loss in 1924 when the stock became worthless. Dalton was not engaged in the business of dealing in corporate stocks. While he owned all of the stock of the Dalton Manufacturing Corporation and managed its business for his own benefit, the corporate business was not his business. Nor can a loss incurred in the sale of corporate stock be regarded as a loss attributable to the business carried on by the corporation. Losses from investment in the stock of a corporation are in no sense incurred in the business conducted by the corporation. They are losses of the investor incurred when the stock is sold or, as in this case, when the corporation has ceased business and disposed of all its property. It therefore follows that the loss was the result of an isolated capital transaction and was not "attributable to the

operation of a trade or business regularly carried on by" Dalton.

Furthermore, if the corporation was but the "alter ego" of Dalton, as held by the District Court (R. 68), and the losses suffered are attributable to the business carried on by the petitioner in the name of the corporation, the losses incurred were deductible as and when they occurred in the course of the business in each of the years 1917 to 1924, inclusive, and can not be claimed in 1924 when the stock became worthless.

ARGUMENT

Petitioners seek a deduction in 1925 of a loss sustained in 1924. To prevail they must be able to point to a specific provision of the statute permitting the deduction and must bring themselves within its terms. *Woolford Realty Co.* v. *Rose*, 286 U. S. 319. The only authority to carry forward a deduction from 1924 to 1925 is found in Section 206 of the Revenue Act of 1924 (*infra*, p. 16), subdivision (b) of which authorizes the carrying forward from one year to another of a "net loss," and subsection (a) provides:

> As used in this section the term "net loss" means the excess of the deductions allowed by section 214 or 234 over the gross income, with the following exceptions and limitations:
>
> (1) Deductions otherwise allowed by law *not attributable to the operation of a trade*

> *or business regularly carried on by the taxpayer* shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. (Italics ours.)
>
> * * * * *

Thus it will be seen that the statute limits the losses that may be carried forward to those "attributable to the operation of a trade or business regularly carried on by the taxpayer."[2] Therefore, the question here presented is whether the loss sustained by Hubert Dalton in 1924 when his stock in the Dalton Manufacturing Corporation became worthless was "attributable to the operation of a trade or business regularly carried on by" him. If it was not, the only use which could have been made of the deduction was against income in 1924 and it could not have affected the petitioner's tax liability for 1925.

Hubert Dalton acquired all of the capital stock of the Dalton Manufacturing Corporation in 1917

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[2] The purpose of the provision referred to was described by the court below as follows (56 F. (2d) 16, 18):

"By the statute, allowing the deductions and carrying over the loss for two years, Congress intended to give relief to persons engaged in an established business for losses incurred during a year of depression in order to equalize taxation in the two succeeding and more profitable years. It was not intended to apply to occasional or isolated losses. Congress had made this distinction. *Anderson* v. *U. S.*, 48 Fed. (2) 201 (C. C. A. 5); *Pabst* v. *Lucas*, 36 Fed. (2) 614 (Ct. App. D. C.); *DeHaven Mfg. Co.* v. *U. S.*, 31 Fed. (2) 999. * * *"

A similar view of the purpose of the statute was expressed in *Anderson* v. *United States*, 48 F. (2d) 201 (C. C. A. 5th).

at a cost of $395,000, and this investment resulted in a total loss in 1924. There is no suggestion that Dalton was engaged in the business of buying and selling stock, and it is well settled that a single isolated transaction does not constitute a trade or business regularly carried on. *Cooper Manufacturing Co.* v. *Ferguson,* 113 U. S. 727, 734; *Bedell* v. *Commissioner,* 30 F. (2d) 622, 624 (C. C. A. 2d); *Phipps* v. *Commissioner,* 54 F. (2d) 469, 471 (C. C. A. 2d).

While Dalton owned all of the stock of the Dalton Manufacturing Corporation, managed its affairs, and operated its business for his own benefit, nevertheless, upon settled principles, the corporation was a separate and distinct *taxable* entity, and the fact that all of the corporate stock was owned by Dalton does not justify disregard of the corporate entity for tax purposes. The decisions holding that corporate entities are not to be disregarded for tax purposes and the principles upon which those decisions are based are fully discussed in Point I of the Government's brief in *Burnet, Commissioner* v. *Commonwealth Improvement Co.*, No. 95, October Term, 1932, at pp. 7–21. Accordingly, we respectfully refer to that discussion for purposes of this case also. It follows from these principles that if the corporation in the instant case sustained a loss it can not be treated as the stockholder's loss, and if the loss was sustained in a business regularly carried on by the corporation such loss can not be

regarded as having been sustained in a business regularly carried on by the petitioner.

Although Dalton was credited with a salary as president of the corporation and would have received any dividends which the corporation might have paid, neither the earning of a salary (*Hughes* v. *Commissioner* (38 F. (2d) 755, 759 (C. C. A. 10th)) nor the receipt of dividends (*McCoach* v. *Minehill & Schuylkill Haven Railroad Co.*, 228 U. S. 295) constitutes the "operation of a trade or business."

The statute excludes from the computation of "net loss" losses not attributable to the operation of the trade or business "regularly carried on by the taxpayer," and so the petitioner asserts, in effect, that the business carried on in the name of the corporation was his personal business, that the corporation was merely an instrument or at most his "alter ego," and that its legal existence should be disregarded. The authorities seem to dispose of this contention, but if it were well founded it would still be quite impossible to regard the loss incurred in 1924, when the stock became worthless, as a loss attributable to the carrying on of the petitioner's business. The fact that the stock became worthless in 1924 was not due to any sudden catastrophe to the corporation, but was a result of a long period of unsuccessful operation of the corporate business. While from the point of view of the petitioner as a stockholder the worthlessness of the stock may be regarded as having been finally determined in

1924, from the point of view of the corporation it was only a result of the losses sustained in prior years. Those losses were deductible as they occurred and could not have been deducted in their entirety in 1924. In view of the treatment of his relations with the corporation in prior years, it would be entirely inconsistent to regard the business of the corporation in 1924 as the petitioner's own business. If it was his own business, dividends declared could not have been included in Dalton's gross income, as required by Section 2 of the Revenue Act of 1916 (c. 463, 39 Stat. 756, 757), Section 216 of the Revenue Acts of 1918 (c. 18, 40 Stat. 1057, 1062) and 1921 (c. 136, 42 Stat. 227, 242).[8]

Similarly, the deduction of $157,035.50 as a bad debt due from the corporation in 1923 (R. 100) should not have been allowed, for Dalton could not have been both debtor and creditor. The petitioner did not claim as his own the business losses sustained in carrying on the business from year to year, as he logically should have done if he is to be regarded as having carried on the business. If such losses had been claimed, there would have been no loss to deduct in 1924. The petitioner claims only the loss suffered in 1924 when his stock in the corporation finally became worthless. Having destroyed the corporate fiction to bring himself within the statute as the proprietor of the business, he asserts the right to restore it to preserve

[8] See *Eisner* v. *Macomber*, 252 U. S. 189, 213.

his status as a stockholder so as to throw the loss into the year 1924 in which none of the losses incurred in carrying on the business are shown to have been sustained. He can not thus play fast and loose, even with a "fiction" of the law. If he is to be regarded as the proprietor of the business, his losses were sustained prior to 1924. If he is to be regarded as a stockholder in the corporation, his loss was not attributable to a business carried on by him and thus could not be made the basis of a net loss to be carried forward from 1924 to 1925.

While at pages 3 and 6 of their brief petitioners refer to six other corporations organized and operated by Dalton, it is to be noted that the Dalton Manufacturing Company was the only corporation in which Dalton is shown to have been interested between 1917 (R. 34) and 1924 or 1925 (R. 18), the period here involved.

Petitioners assert that they do not seek to disregard the corporate entity of the Dalton Manufacturing Company, but that the corporate entity "taken as a whole was an instrument used by Dalton in furtherance of his own personal business." (Br. 6.) Obviously, a corporation could be used as "an instrument" only by constituting it an agent. There is nothing to indicate that the Dalton Manufacturing Company ever purported to act as the agent of Dalton. In fact, the record discloses the exact reverse. Dalton as president, treasurer, and director of the corporation was the agent (instrumentality) through which the corporation acted.

His acts performed in the regular course of business were the acts of the corporation unless the corporate entity is disregarded. The corporation's acts were not his and the corporation was a "taxpayer" regularly carrying on its own business.

It is contended (Br. 9) that the taxpayer's trade or business was not merely that of inventing, that it included the exploiting of those inventions and putting them on a paying basis, by developing, manufacturing, improving, and selling the patented articles, putting them on the market. The difficulty with this position is that it confuses Dalton's business with that of the corporation. Dalton, as an individual, invented and perhaps improved upon his inventions. The loss which he sustained when his stock became worthless was not attributable to such activity. It was the corporation that developed, manufactured, and placed the patented articles upon the market. Thus, if Dalton's business had ever been that of developing, manufacturing, improving, and selling his inventions, it ceased to be his business when the Dalton Manufacturing Company took over that part of his operations. In effect, he went out of that kind of business and the corporation went into it. Losses incurred in the business which Dalton had parted with were incurred by the corporate taxpayer in prior years and the loss on his stock was not attributable to a business regularly carried on by him as a taxpayer. Only by regarding the corporation's business as Dalton's business can it be said that he incurred a

loss in a business carried on by him. Such a view erroneously treats losses incurred in the course of a business regularly carried on as incurred when the business was terminated. The Revenue Acts treat corporations and individuals as having separate entities as taxpayers. The petitioner's argument upsets the whole scheme of these statutes.

It necessarily follows that Dalton's loss was "not attributable to the operation of a trade or business regularly carried on by" *him* within the meaning of Section 206 (a) (1). Therefore, such loss was not to be taken into consideration in computing the net loss which petitioners were entitled to carry forward from 1924 to 1925 under the provisions of Section 206 (b). *Goldberg* v. *Commissioner*, 36 F. (2d) 551 (App. D. C.); *Anderson* v. *United States*, 48 F. (2d) 201 (C. C. A. 5th). When the loss was used as a deduction against income for 1924 it had served its purpose and nothing remained which could be carried forward. It was, therefore, one of the losses under Section 214 of the Revenue Act of 1924 which could not be used in computing a postponable "net loss" under Section 206.

It is conceded that the decision herein is in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Washburn* v. *Commissioner*, 51 F. (2d) 949, and the Court of Appeals for the District of Columbia in *Clark* v. *Burnet*, 59 F. (2d) 1031, pending in this Court on certiorari, No. 180, present term. However, it is our contention that those decisions are unsound in principle

and disregard corporate entities in violation of fundamental and well-established principles of law and that they should not be followed.[4]

CONCLUSION

The decision of the Circuit Court of Appeals is in accordance with well established principles of law and should be affirmed.

Respectfully submitted.

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OCTOBER, 1932.

[4] For an analysis of the decision in the *Washburn* and *Clark* cases, see Memorandum for the Respondent (pp. 7–10) filed in answer to petition for certiorari herein.

APPENDIX

REVENUE ACT OF 1924, C. 234, 43 STAT. 253, 260

SEC. 206. (a) As used in this section the term "net loss" means the excess of the deductions allowed by section 214 or 234 over the gross income, with the following exceptions and limitations:

(1) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall be allowed only to the extent of the amount of the gross income not derived from such trade or business;

(2) In the case of a taxpayer other than a corporation, deductions for capital losses otherwise allowed by law shall be allowed only to the extent of the capital gains;

* * * * *

(b) If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called "second year"), and if such net loss is in excess of such net income (computed without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called "third year"); the deduction in all cases to be made under regulations

prescribed by the Commissioner with the approval of the Secretary.

* * * * * *

[U. S. C., Title 26, Sec. 937.]

TREASURY REGULATIONS 65, RELATING TO THE INCOME TAX UNDER THE REVENUE ACT OF 1924

ART. 1621. *Net losses, definition, and computation.*—The term "net loss" as used in the statute applies to a net loss during the taxable year in a trade or business regularly carried on by the taxpayer. Included therein are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business. (See article 1654 with reference to the deduction of capital net losses.) In order to be entitled to claim an allowance for a "net loss" the taxpayer must have suffered an actual net loss in a trade or business during the taxable year. The amount properly allowed may be neither the loss reflected by the return filed for the purpose of the income tax nor the net loss shown by the taxpayer's profit and loss account, but is to be computed according to the statute, as follows:

(1) In the case of an individual it is the amount by which the deductions allowed under section 214, excluding—

(a) the amount by which the deductions otherwise allowed by law but not attributable to the operation of a trade or business regularly carried on by the taxpayer exceed the amount of gross income not derived from such trade or business;

(b) the amount by which the deductions for capital losses otherwise allowed by law exceed the capital gains; and

(c) the amount by which the deduction for depletion exceeds the amount which would be allowable if computed without reference to discovery value,

exceeds the sum of the following:

(a) the gross income of the taxpayer for the taxable year as computed under section 213; and

(b) the amount by which the interest received free from taxation under Title II of this Act exceeds the amount of interest paid or accrued which is not allowed as a deduction by section 214 (a) (2);

* * * * *

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